FREQUENTLY ASKED QUESTIONS
SECTION 302/318 SETTLEMENT INITIATIVE
Supplement # 1
November 21, 2002

Administrative and Procedural

Q. The settlement initiative states that the taxpayer is to produce transactional documents to support the basis shifting transaction upon IRS request. The lists of transactional documents the taxpayer is required to produce are posted to the OTSA website. Are we supposed to issue an IDR to the taxpayer and attach this list if they notify us they want to participate in the settlement?

A. No. The agent should first determine whether or not they already have the documents on this list and then only request the documents that are missing. The agent should not be attaching a copy of the list of documents to a letter or IDR and issuing it to the taxpayer.

Q. If the taxpayer has not sold all of their stock, will they get the 20% settlement allowance on the remaining basis shift that they didn't use in the year they sell the final shares?

A. No. The 20% is applied to the claimed basis shift as shown on the filed returns. In the year of the final disposition of the remaining shares the gain or loss will be calculated on the actual basis without regard to any inflated basis from the basis shift. In situations where there are remaining unsold shares of stock, secure a closing agreement to agree upon the basis in the remaining shares of stock.

Q. The taxpayer filed a disclosure statement for the 98 tax year on the basis shift transaction and met all the requirements for waiver of penalty under the disclosure initiative. However, the transaction straddled two years - 98 & 99, but the disclosure was only for the 98 year and not the 99 year. Do they qualify for penalty waiver for the 99 year?

A. Yes, because it is the same transaction that was disclosed on the 98 year.

Q. Taxpayer has a legal opinion letter for the basis shift transaction, but will not provide it to us without a signed privilege waiver form. Should we sign the form?

A. There is an approved privilege waiver agreement form available for download on the OTSA web-site: http://lmsb.irs.gov/hq/pftg/otsa/tax_shelter_disclosure.htm The DFO must sign these waivers. **Note:** This waiver form is only used in connection with cases associated with Announcement 2002-02.

Q. The transaction straddles more than one year. Will the deemed transaction costs be pro-rated among all of the years?

A. No. The deemed transaction costs will be allowed in the first year of the transaction.

Q. The Announcement does not indicate the treatment to be given to the swaps that were entered into by taxpayers that did OPIS. These taxpayers are far more likely to settle if the swaps are treated as an investment like the foreign bank stock and options. If the swap is not treated as an investment and the taxpayers get no deduction for its cost, some taxpayers will believe they are receiving worse treatment under the terms of the Announcement relative to taxpayers that did FLIP.

A. The swap is not a direct investment. Therefore, it should be treated as we treated the warrant in a FLIP transaction.

Q. How should taxpayers treat proceeds on the swap?
A. You would ignore any net income over cost of the swap. The total cost of the swap is used in computing the deemed transaction costs.

Q. In many FLIP cases, the taxpayer cut one check for a warrant, and the fees were paid from within the Foreign Company. In other cases, the taxpayer cut separate checks for the cost of the warrant and fees. May the fees paid separately in the latter situation be included within the amount from which "deemed transaction cost" is calculated?
A. Based on wording of the settlement, only the amount identified initially as cost of the warrant would be included. The rest of the fees would be disallowed and will not be considered in the calculation of the deemed transactions costs. The calculation for deemed transactions costs treats all taxpayers the same.

Q. How should taxpayers treat proceeds on the warrant?
A. Proceeds of warrant should be netted against cost. Both gains or losses on the warrant will not be recognized for purposes of the settlement. Any monies received on the warrant are not considered in computing the deemed transactions costs.

Q. Can we adopt a procedure whereby eligibility for installment payments can be determined prior to acceptance of the offer? Can acceptance of the offer be conditioned on the taxpayer being allowed to make payment in installments?
A. No. The Installment Procedures currently in place apply to all taxpayers equally. ***There are no conditions placed on the taxpayer's acceptance or refusal of the offer.***

Q. Many taxpayers are unwilling to believe that the Service will not make a better offer if only a few taxpayers decide to participate in the current settlement initiative. It would help us to convince these taxpayers to settle if language could be put in a closing agreement to the effect that taxpayers will receive the benefit of any future global settlement that is more beneficial to the taxpayer and that is made prior to a decision being reached by any court.
A. The public statements made by Internal Revenue Service Officials in respect to this matter do not indicate future offers will be forthcoming.

Q. Does the swap amount included in the deemed transaction costs include gross paid for swap or net after any payout on the swap?
A. The warrant and the swap should be treated the same based on the gross amount.

Q. One of our cases is an S Corp with 25 individual investors and 15 trusts related to some of the 25 investors. This is non-TEFRA. Do we get one closing agreement from the S Corp or do we need to get one from each investor/trust/beneficiary?
A. In non-TEFRA cases, each shareholder can agree or disagree with any flow through adjustment. Each entity needs its own agreement.

Q. On some Strategy 3 Cases, taxpayers are reporting gains on the sale of Stock rights on the Foreign bank. Is this correct?
A. These gains should be disallowed per the settlement initiative.

Q. What is meant by "settlement" initiative computation document?

A. There is no pro-forma computation document. However, there are examples posted on the web site that can assist you with the computations on your specific case. You may "plug in" the variables as you go through the example. These examples are not going to be released to the public at this time.

Q. What is the appropriate way to determine deemed transaction costs? The announcement states that transaction costs will be deemed to be 8% of the sum of the amount of the basis shift and the cost of the option/warrant in the foreign corporation. The previous FAQs indicate that transaction costs will only be allowed in year one. Agents have requested clarification with respect to the basis shift amount in the later tax year. Should this amount be added to the year one basis shift and the warrant price for purposes of determining the deemed transactions costs?

A. For purposes of consistent treatment the calculation should include the total basis shift amount.

Example:
T/P sells 80% of FB stock in Year 1 claiming a basis shift loss of $8,000,000 and sells the remaining 20% in Year 2 claiming a basis shift loss of $2,000,000. Warrant in Foreign Corporation is $400,000.

Deemed transaction costs calculation allowing full basis shift:

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  8,000,000
    400,000
  2,000,000
 10,400,000  * 8% =  832,000 * 20% =  $166,400
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The full $166,400 is allowed only in the first year.

Q. What is the definition of "claimed basis shift"?

A. "Claimed" indicates the amount actually shown on the return and if TP used a different amount, then the unclaimed portion is not considered. Otherwise, we would be allowing a loss for which there was no original tax benefit.

Q. Once a taxpayer indicates they wish to participate in the settlement initiative, can the offer be rescinded?

A. Yes, the taxpayer does this by not signing the closing agreement.

Q. Is there a provision for an extension beyond the 12/3/02 deadline date for taxpayers to accept the settlement offer?

A. No.

Q. Locally we flag cases for Section 6404(g). This allows the PSP to consider interest which would be inappropriate to charge (I believe the law involves an 18 month rule and 1040s). In tax years ending December 31, 1998 there is an 18 month rule. Does the governments issuance of Notice 2001-45 affects this section of law?

A. The issuance of Notice 2001-45 does not constitute notice to the taxpayer for purposes of IRC 6404(g). The Service provides notice of I.R.C. 6404(g) if it sends a notice in writing to the taxpayer at the taxpayer's last known address and that notice includes the amount of the liability, the basis for that liability, and sufficient information or explanation regarding the adjustment to enable the taxpayer to challenge the

adjustment. Math error notices, Underreporter Program (URP) notices, revenue agent reports, 30-day letters with accompanying RARs, and statutory notices of deficiency with the accompanying Form 886A, Explanation of Items, generally will be sufficient notices for purposes of I.R.C. § 6404(g). The general Notice 2001-45 does not provide the statutorily required information with respect to the taxpayer's individual income tax liability.

Q. Members of an LLC personally purchased the FB stock. All of the stock was transferred to the LLC except for one of the members. The 1998 TEFRA statute for the LLC was protected. However, at that time, it was not known that one of the members still held stock personally and the 1998 statute for that member, "R" was not extended personally. In other words, "R" claimed a TEFRA flow through loss resulting from a basis shift AND claimed an individual basis shift loss. "R" has filed an NOL carryback from 2002-1998. Is "R" individually eligible for the settlement initiative computation, as it would affect the NOL computation on the loss he claimed separately from the flow through loss?

A. Since the individual statute has expired, the settlement initiative computation cannot be used in computing corrected taxable income against which the carryback loss is to be claimed since the 1998 1040 statute has expired. Therefore, under item # 6 of the eligibility list in the Announcement 2002-97 this taxpayer is not eligible.

Penalty

Q. Does the registering of a tax shelter itself constitute disclosure for purposes of waiver of the penalty?

A. No, registration of a tax shelter only protects the promoter from 6707 penalties

Q. If the taxpayer invests in a registered shelter, and puts that registration number on his return, does that constitute "disclosure" for purposes of waiver of the penalty?

A. No. However, a taxpayer's disclosure of its participation in the transaction in accordance with Treas. Reg. 1.6011-4T(c) would be evidence of good faith. The taxpayer would still need to demonstrate reasonable cause, which ordinarily would be satisfied by a good legal position supporting the position on the return. Failure to disclose by a taxpayer who is not subject to the disclosure requirements would not by itself be indicia of bad faith. But, taxpayers who did disclose would be in a better position to support facts and circumstances for the agent to conclude that the reasonable cause and good faith exception applies. Only disclosures under Announcement 2002-2 have penalty protection.

Q. Few agents appear to be drawing any distinction between taxpayers that were not able to participate in the Disclosure Initiative 2002-02 program because they were already under audit and taxpayers that could have participated in that program but chose not to do so. Should this not be a major factor in the determination as to whether penalties are applicable?

A. The question seems to imply that penalties should only be considered in cases where a taxpayer had the opportunity to disclose but failed to do so. This is not a proper reading of Announcement 2002-97. The announcement provides for penalty waiver only for those taxpayers who disclosed pursuant to Announcement 2002-2. We note that there may be some confusion among practitioners as a result of Rev. Proc. 2002-67, which deals with contingent liability cases. In that settlement initiative, taxpayers who either

disclosed under Announcement 2002-02 or could not disclose because they were already under examination and elect the fixed rate option settlement offer will not be subject to the accuracy-related penalty. We note that penalty consideration under the basis shift initiative, however, does not follow this approach.

The power point presentation materials circulated concurrent with release of the settlement initiative reinforces the point that application of penalties should be a facts and circumstances determination made on a case-by-case basis for all taxpayers who were ineligible for penalty waiver under the disclosure procedure. The materials identify the following non-exclusive list of factors to consider: (1) sophistication of the taxpayer; (2) involvement in making investment decisions; (3) attempt to obtain outside opinion other than the one provided by the promoter (note, a failure to obtain a second opinion does not mean the penalty automatically should be imposed); (4) timing of the opinion in relation to filing of return; and (5) extent to which it appears the taxpayer took additional steps to conceal transaction. Work with your local attorney to assess whether the penalty should or should not be imposed. Remember that the decision to impose or not impose the penalty must be made by your DFO.

Q. What options are available to a taxpayer that wants to settle when the agent has determined that penalties are applicable? Note that we have yet to talk to a taxpayer who would be willing to enter into a closing agreement on the tax and interest that leaves penalties unresolved.

A. As stated in Announcement 2002-97, participating in the settlement initiative does not preclude taxpayers from contesting the application of penalties through normal audit and deficiency procedures. Therefore, the application or non-application of penalties will proceed without regard to whether the taxpayer participates in the settlement initiative.

TEFRA

Q. Can a partner in a TEFRA partnership accept the settlement offer independently of the partnership who does not choose to accept the offer?

A. A partner can agree to the adjustments at any stage of the partnership proceedings by signing a waiver and a closing agreement. Consult with your local TEFRA coordinator about the appropriate waiver form to use.